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Managing Director & Principal*

August 5, 2008

Ms. Anne Stausboll
Interim Chief Investment Officer
California Public Employees' Retirement System
400 P Street, Suite 3492
Sacramento, CA 95814

Re: Environmental Equity Managers Contract Renewal Recommendation¹

Dear Anne,

You requested Wilshire's opinion with respect to Staff's recommendation pertaining to the annual review and renewal of the contracts of the external domestic and international environmental equity managers. Wilshire concurs with Staff's recommendations, and our comments regarding all 5 equity portfolios are below.

In addition, Wilshire has had a number of discussions about Staff regarding the future of this program, and these discussions remain ongoing. One of the main issues we are struggling with is how to make this program live up to its original charge of reducing investment risk from climate change and potentially "doing good" while still "doing well." One concept that Wilshire and Staff have been discussing is to change the focus of the program from simply one of conventional investment products with an environmental screen applied to a program that is focused more on public entities in the renewable energy, recycling, battery production, or carbon sequestration industries. In this way, rather than simply divesting the worst polluters from a small section of the equity portfolio, CalPERS might be able to encourage the growth and development of industries and products that can result in positive change. We will keep the Investment Committee apprised of these discussions as they move forward.

Discussion

During the 2008 fiscal year, the CalPERS environmental external manager program outperformed its benchmark by more than 1%, but still declined with the greater equity market, returning a total of -9.58% for the year. Surprisingly, the managers in general were able to add value over the benchmark despite an underweight to extractive

¹ Wilshire's Code of Conduct requires us to disclose which of the above firms are clients of Wilshire's Analytics Services Division and as such pay Wilshire a fee for the licensing of analytical software used in investment management. Wilshire's consulting division has no business relationship with them. This disclosure has been delivered under separate cover and is included as an attachment to this agenda item.

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industries, which have been some of the best performing industries this year due to the continued appreciation in the prices of raw materials and energy. This leads us to conclude that it is possible for an environmentally targeted portfolio to actually add value over the benchmark, despite the reduced selection set of stocks the managers are given.

However, this performance may also have been more of a result of manager skill than passive industry bias since three of the five portfolios underperformed the unconstrained equivalent portfolios for the year. In a year in which active managers generally fared poorly, the five portfolios selected for this program, on average, did very well.

We support the annual contract renewal recommendation as the current stable of managers are relatively new and the improving performance track record of the overall program is not sufficiently long enough to determine if the managers are skilled or unskilled, or if the managers were victims in the first two years of adverse market movements in the sectors which they underweight. Staff has the authority to terminate managers who do not perform as expected, and they have used that authority when necessary and appropriate. The renewal of these contracts does not in any way preclude Staff from exercising the authority to terminate any manager who ceases to perform as expected subsequent to contract renewal. In addition, as noted above, Staff is in discussions with Wilshire about the future of this program, and renewing these contracts allows all more time to determine how CalPERS' assets can best be used to mitigate the effects of climate change.

AXA Rosenberg

AXA Rosenberg has managed a US large cap core environmental equity portfolio for CalPERS since April 1, 2006. AXA employs a quantitative strategy where the true value of each of 19,000 stocks in every market in the world is recalculated every three minutes, and each portfolio is subsequently optimized relative to the client's benchmark based on the results of any changes. Unlike many quantitative managers who employ a multi-factor model which is based on independent assumptions of what makes a stock cheap or expensive, AXA's models price each security based on what the market is paying for such securities. For example, the consumer software portion of Microsoft is valued based on where the market is valuing all the other consumer software companies, and then is added to the business software's valuation based on the current market valuation for business software companies. To the extent that the computed total valuation differs from the current stock price, AXA's models indicate whether the stock should be bought or sold. An equally quantitative methodology is used to predict the future earnings of companies, and this forecast is combined with the valuation model to construct a portfolio of stocks with index-like characteristics but superior growth and cheaper valuation. Since inception, this portfolio has had an annualized outperformance of 1.24%, completely as a result of a 3.79% outperformance in fiscal year 2008.

New Amsterdam

New Amsterdam was hired on February 1, 2006 to manage a US large cap core environmental equity portfolio for CalPERS. This is an active and fundamental portfolio that tends to have concentrated, high-conviction positions in 40 to 45 stocks. Although the manager has had a slight growth bias in the portfolio, which hurt performance during a time of general large value outperformance in fiscal years 2006 and 2007, this bias did significantly improve performance during fiscal 2008 when growth outperformed value. Since inception, the manager has lost an annualized 0.25% versus the benchmark, but obviously made great progress in catching up to the benchmark over the past year.

Last year, this manager was under review by CalPERS Staff and was the subject of an on-site due diligence review by Wilshire Associates. Staff and Wilshire decided to allow the manager more time to improve performance, and were rewarded for that patience over the past year.

Brandywine

Brandywine was hired on May 1, 2006 to manage a core-oriented developed markets ex-US environmental portfolio for CalPERS. Brandywine uses a combination of quantitative initial screens and fundamental analysis to pick what is essentially a moderately value-biased portfolio, although it is benchmarked against a core index. This bias has substantially impacted performance in quarters where growth outperformed value, especially in the second calendar quarter of 2007 and most of fiscal 2008. The manager is heavily reliant on fundamental valuation analysis and although this management style should be successful over time, it has not been a successful strategy since the manager was hired. The non-US portfolio performed poorly in its first calendar quarter following funding, and had almost made up all of that value lost by the end of the first calendar quarter of 2007, but then steadily lost value relative to the index throughout fiscal years 2007 and 2008. The manager now trails the benchmark by 3.73% annualized since inception, and it the only truly disappointing manager in this group. We recommend extending this manager's contract to allow Staff and Wilshire time to determine if this manager should remain in the program.

State Street Global Advisors

State Street Global Advisors (SSGA) manages two environmental equity portfolios for CalPERS – US large cap core and non-US developed markets. Both portfolios are managed in a similar fashion, with quantitative models driving the stock selection process. Portfolio construction is controlled by a computer optimizer that selects the “best” stocks (based on valuation, expected growth, riskiness, etc.) with the goal of closely tracking the overall characteristics of the index. The US portfolio performed well in the year after funding, lost 0.73% in the second year, and just missed the benchmark in the most recent year, underperforming by 0.26%. Given that quantitative portfolios in general had a very

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difficult year in fiscal 2008 due to a number of factors related to the on-going hedge fund de-leveraging and credit crunch, we believe that this near-miss on performance is still acceptable. Since inception, this portfolio trails the benchmark by 0.34% on an annualized basis.

The non-US portfolio is managed in an identical manner to the US portfolio, but has had substantially better results, adding value in all three years and generating an annualized value-added of 2.67%.

Conclusion

Through the on-going activities of both CalPERS' consulting team and Wilshire's Manager Research Group, we closely monitor the performance and investment processes of all of CalPERS' managers. In addition, as noted above, we recommend that one of these portfolios receive special review by both Wilshire and Staff. At this time, Wilshire concurs with Staff's recommendation to renew the contracts for all of the environmental equity managers, as CalPERS has the right to terminate any on 30 days notice and is currently reviewing the future direction of this investment program.

Sincerely,

A handwritten signature in black ink, appearing to read "Michael Schlachter", with a long horizontal flourish extending to the right.

Michael C. Schlachter, CFA